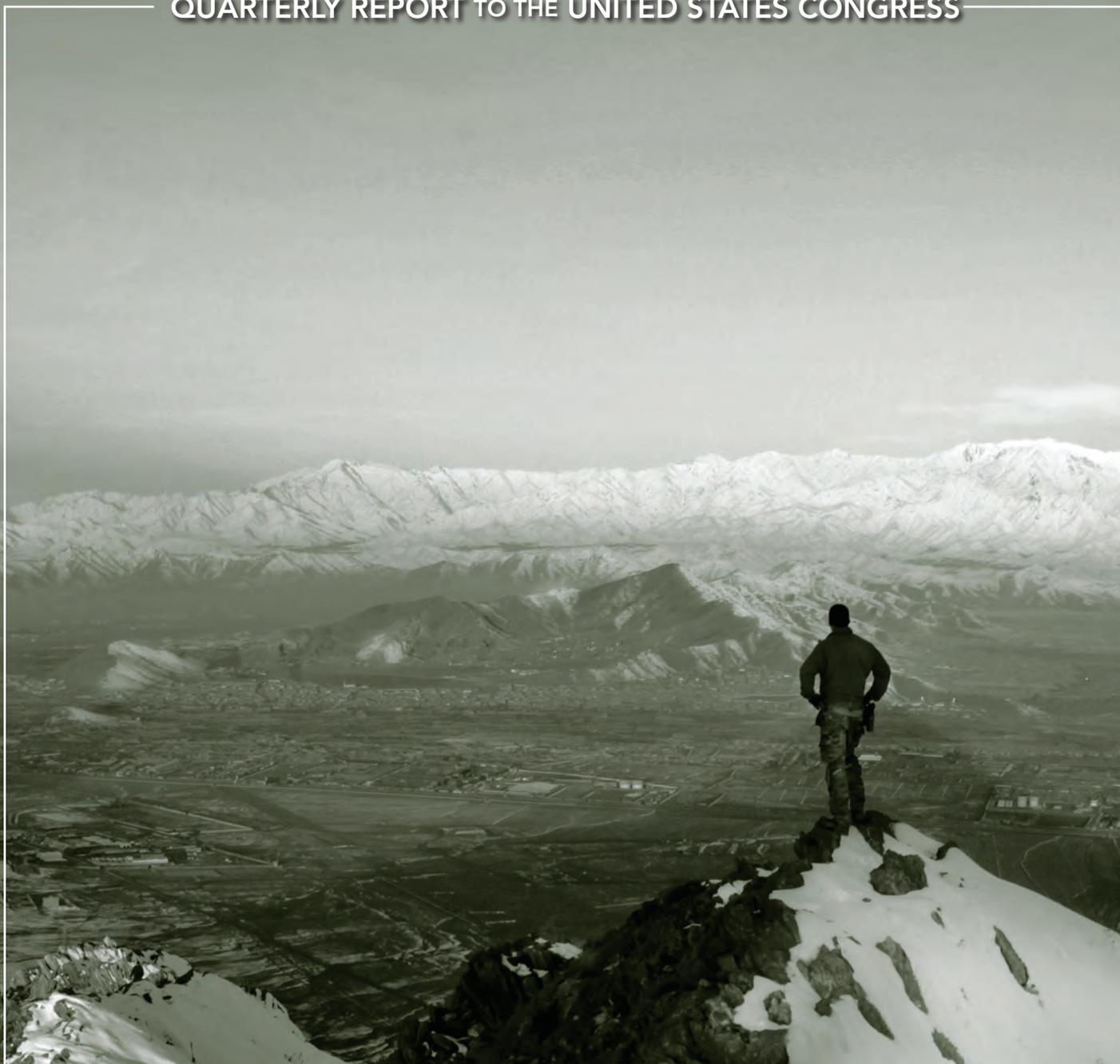


SIGAR

Special Inspector General for
Afghanistan Reconstruction

JUL 30
2014

QUARTERLY REPORT TO THE UNITED STATES CONGRESS





The National Defense Authorization Act for FY 2008 (P.L. 110-181) established the Special Inspector General for Afghanistan Reconstruction (SIGAR).

SIGAR's oversight mission, as defined by the legislation, is to provide for the independent and objective

- conduct and supervision of audits and investigations relating to the programs and operations funded with amounts appropriated or otherwise made available for the reconstruction of Afghanistan.
- leadership and coordination of, and recommendations on, policies designed to promote economy, efficiency, and effectiveness in the administration of the programs and operations, and to prevent and detect waste, fraud, and abuse in such programs and operations.
- means of keeping the Secretary of State and the Secretary of Defense fully and currently informed about problems and deficiencies relating to the administration of such programs and operation and the necessity for and progress on corrective action.

Afghanistan reconstruction includes any major contract, grant, agreement, or other funding mechanism entered into by any department or agency of the U.S. government that involves the use of amounts appropriated or otherwise made available for the reconstruction of Afghanistan.

Source: P.L. 110-181, "National Defense Authorization Act for FY 2008," 1/28/2008.

(For a list of the congressionally mandated contents of this report, see Section 3.)

Cover photo:

A Coalition soldier looks over a valley in Kabul Province, Afghanistan. (U.S. Army photo)



SPECIAL INSPECTOR GENERAL FOR
AFGHANISTAN RECONSTRUCTION

I am pleased to submit to Congress, and to the Secretaries of State and Defense, SIGAR's 24th quarterly report on the status of the U.S. reconstruction effort in Afghanistan.

On my most recent trip to Afghanistan in June, I was repeatedly reminded that the success of the \$104 billion reconstruction effort in Afghanistan hinges on President Hamid Karzai being able to peacefully transfer power to a democratically elected successor. When I arrived, Afghanistan had just held a runoff election between presidential candidates Ashraf Ghani and Abdullah Abdullah, despite Taliban threats to violently disrupt it. Unlike the first round of elections, however, in which the leading candidates largely accepted the results, the Abdullah campaign contested the results of the runoff and accused the Afghan election bodies of massive fraud.

With Abdullah's supporters threatening to set up a parallel government, Secretary of State John Kerry brokered an agreement between the two candidates to conduct an audit of all 8.1 million ballots cast and to form a government of national unity once the winner is declared. The audit was still under way when this report went to press. Because the effectiveness and legitimacy of government is a key element in determining the success of reconstruction, SIGAR, along with other Executive Branch agencies, will be watching closely to see how the election dispute is resolved.

Earlier this quarter, President Obama announced that if the next Afghan president signs a Bilateral Security Agreement with the United States, 9,800 U.S. forces will remain in Afghanistan after U.S. combat operations end in December, and will draw down to roughly 4,900 by the end of 2015. By the end of 2016, the force will be reduced to a small military presence at the U.S. Embassy in Kabul.

The U.S. effort to bring its men, women, and materiel home from Afghanistan already is proceeding at a tremendous pace, as I witnessed on my trip. At Kandahar Airfield and Camp Leatherneck in Helmand Province, I saw vast amounts of equipment being readied for return to the United States. I saw trucks and Mine-Resistant Ambush-Protected (MRAP) vehicles being disassembled. Everything from metal poles to canvas tent covers was being sorted into boxes to be sent home or sold as scrap. The retrograde has been called the greatest feat of military transport in recent history. Those in charge of it deserve our nation's gratitude.

With the United States' military drawdown, the Afghan National Security Forces (ANSF) will be responsible for securing Afghanistan. To determine if the ANSF has the ability to sustain its recent military successes and keep the country from again becoming a launchpad for terrorist attacks, SIGAR is conducting a number of audits of ANSF capabilities. For example, this quarter SIGAR issued an audit finding that, largely because of security concerns, a U.S. contractor was unable to provide the Afghan National Army (ANA) with the training and maintenance needed to operate its Mobile Strike Force Vehicles. Another audit raised concerns about the ANA's ability to account for some 465,000 U.S.-provided small

arms. SIGAR has ongoing audits of ANSF personnel data, the ANA Engineering Brigade's equipment, the effectiveness of the Counter Narcotics Police of Afghanistan, and U.S. support for the Afghan Air Force. SIGAR also announced a new audit this quarter of the Afghan Local Police program, which trains local Afghans to defend their communities against insurgents and other illegal armed groups.

SIGAR is also initiating a new series of lessons-learned reports to extract useful guidance for future operations of the most expensive reconstruction effort ever underwritten by the U.S. taxpayer. One of my concerns is that U.S. agencies often lack metrics for determining whether their projects and programs are contributing to the achievement of overall U.S. strategic objectives. By contrast, SIGAR's lessons-learned reports will assess the extent to which spending in Afghanistan did or did not help the United States achieve its reconstruction goals. As the only oversight agency with the mandate to oversee all U.S.-funded projects and programs in Afghanistan, SIGAR is in a unique position to draw conclusions for the U.S. government to consider when planning any future large-scale development and military-assistance efforts. Most experts agree that any future such assistance efforts will follow a "whole of government" approach.

Section 1 of this report discusses a key issue facing the next Afghan government: the recurring, multibillion-dollar fiscal gap between its domestic revenues and its costs, particularly the costs of its army and national police. This year, donor grants will make up most of the shortfall, but aid to Afghanistan has been falling since 2010, and history suggests it will fall even more sharply after U.S. and Coalition troops are withdrawn. Government budget shortfalls could severely undermine the central government and overall political stability. This quarter an Afghan Local Police unit cut the power lines from Kabul to eastern Laghman and Nangahar Provinces in retaliation for not being paid for three months. This could be a sign of the turmoil to come if the Afghan government cannot meet payrolls.

Large areas of the country—larger even than SIGAR anticipated last year—will soon be off limits to U.S. personnel due to base closures and troop withdrawals. SIGAR plans to produce new oversight-access maps showing the areas in which U.S. government employees are still able to conduct in-person site visits. Nevertheless, we will continue to provide aggressive oversight of the U.S. reconstruction effort by using satellite imagery and by hiring Afghans and third-country nationals to augment our ability to carry out site visits.

The 30 audits, inspections, special projects, and other reports SIGAR issued this quarter examined programs and projects worth approximately \$18.2 billion. Unfortunately, most uncovered poor planning, shoddy construction, mechanical failures, and inadequate oversight.

For example, an inspection of Baghlan Prison revealed that the \$11.3 million facility requires extensive repairs due to severe damage. Another inspection found that although Afghan and U.S. military personnel at Shindand Airbase had been provided with incinerators, they were burning waste in open-air burn pits in violation of Department of Defense regulations. A third inspection determined that a U.S.-funded cold- and dry-storage facility was not being used. On the positive side, another audit found that the State Department had successfully implemented a large percentage of SIGAR's audit recommendations, reducing the risk of waste, fraud, and abuse of reconstruction funds.

SIGAR also completed three financial audits this quarter that identified over \$2.5 million in questioned costs. SIGAR's financial-audits program has identified nearly \$78 million in questioned costs to date. Section 2 summarizes our findings and recommendations.

Since my last report to Congress, SIGAR has opened 26 new investigations and closed 46, bringing the total number of ongoing investigations to 318. The criminal fines, restitutions, forfeitures, and cost savings to the U.S. government from SIGAR's ongoing investigations in this reporting period amounted to approximately \$3.1 million. SIGAR's suspension and debarment program referred 16 individuals and 39 companies for suspension or debarment based on allegations that they engaged in fraud or failed to perform under contracts valued at over \$180 million.

This quarter, I must once again reiterate my concerns about the policies of the U.S. Army's suspension and debarment program. As I have pointed out in our last five quarterly reports, the Army's refusal to suspend or debar supporters of the insurgency from receiving government contracts because the information supporting these recommendations is classified is not only legally wrong, but contrary to sound policy and national-security goals. It is troubling that our government can and does use classified information to arrest, detain, and even kill individuals linked to the insurgency in Afghanistan, but apparently the same classified information cannot be used to deny these same individuals their rights to contract work with the U.S. government. I continue to urge the Secretary of Defense and Congress to change this misguided policy and impose common sense on the Army's suspension and debarment program.

In this difficult period of transition for Afghanistan, my staff and I remain dedicated to working with Congress, implementing agencies, and other oversight bodies to fulfill U.S. mission objectives for reconstruction and to protect the U.S. taxpayer's investment.

Respectfully,

A handwritten signature in black ink, appearing to read 'John F. Sopko', with a long, sweeping horizontal line extending to the right.

John F. Sopko
Special Inspector General for Afghanistan Reconstruction

EXECUTIVE SUMMARY

This report summarizes SIGAR's oversight work and updates developments in the three major sectors of Afghanistan's reconstruction effort from April 1 to June 30, 2014.* It also discusses whether the reconstruction is sustainable. During this reporting period, SIGAR published 30 audits, inspections, alert letters, and other reports assessing the U.S. efforts to build the Afghan security forces, improve governance, and facilitate economic and social development. These identified a number of problems, including a lack of accountability, failures of planning, construction deficiencies, and other threats to health and safety. The monetary results from SIGAR's ongoing investigations totaled \$3.1 million from criminal fines, restitutions, forfeitures, contract monies protected, and civil settlement agreements. SIGAR investigations also resulted in two arrests, three criminal informations, three plea agreements, and two sentencing in the United States. In Afghanistan, one subject was arrested, three Afghans were barred from access to military installations, and two government contractors were terminated. SIGAR's suspension and debarment program referred 16 individuals and 39 companies for suspension or debarment based on allegations that they engaged in fraud and non-performance in contracts valued at over \$180 million.

SIGAR OVERVIEW

AUDITS

SIGAR produced three performance audits, three financial audits, three inspections, and one alert letter.

The **performance audits** found:

- The State Department implemented nearly 75% of SIGAR's audit recommendations in a timely, successful way, reducing the risk of fraud, waste, and abuse of Afghan reconstruction funds.
- Poor Afghan National Security Forces (ANSF) record keeping limits the Department of Defense's (DOD) ability to monitor weapons after they are transferred to the ANSF.
- The Afghan National Army (ANA) may not be able to sustain the mobile strike force vehicles (MSFV) it was given, and a DOD contractor did not meet contract requirements to provide operator and maintenance training for which it was paid as part of the program.

The **financial audits** identified over \$2.5 million (bringing the total to \$78 million to date) in questioned costs as a result of internal-control deficiencies and noncompliance issues. These deficiencies and noncompliance issues included, among other things, failure to

follow competitive bidding procedures, improper cost allocations, lack of supporting documentation, over-reimbursement of indirect costs, poor record retention, unexplained discrepancies between a contractor's general ledger balance and various supporting documents, and failure to conduct vendor-suspension and debarment checks.

The **inspection reports** of U.S.-funded facilities found:

- Severe damage to the \$11.3 million Baghlan Prison requires extensive remedial action.
- The Afghan military was using open-air burn pits in violation of DOD regulations at Shindand Airbase instead of the incinerators the U.S. Army Corps of Engineers had provided them because the burn pits were cheaper to operate.
- The \$2.89 million Gereshk Cold and Dry Storage Facility has not been used to date.

The **audit alert letter** raised concerns that:

- DOD plans to provide C-130 planes to the Afghan Air Force that it may not need.

EXECUTIVE SUMMARY

NEW AUDIT

This quarter, SIGAR initiated a new performance audit to assess the Combined Joint Special Operations Task Force-Afghanistan's (CJSOTF-A) implementation of the Afghan Local Police (ALP) program.

SPECIAL PROJECTS

During this reporting period, the Office of Special Projects issued a review of the safety of spray foam insulation systems used in ANA facilities. In addition, the office issued letters on:

- IRD's confidentiality agreement
- ANP mobile money pilot program
- The U.S. Department of Agriculture's response to SIGAR's soybean inquiry
- Canceled USAID contracts
- Afghan National Police (ANP) patrol boats and the Combined Security Transition Command-Afghanistan's (CSTC-A) response to the ANP patrol boats inquiry
- The United Nations Development Programme's oversight of the Law and Order Trust Fund for Afghanistan (LOTFA)
- Insights and observations of Professional Service Council members
- IRD whistleblower protections
- Small Business Innovation Research study
- Maintenance of DOD- and USAID-funded roads
- ANP patrol boats disposition
- Kandahar bridging solution
- Reconstruction program data information
- Ecolog Inc. and Fluor Corporation's recruitment of third country nationals

INVESTIGATIONS

During the reporting period, SIGAR's ongoing investigations saved the U.S. government \$500,000. Criminal fines, restitutions, and forfeitures amounted to an additional \$600,000, and two civil-settlement agreements with a combined total of \$2 million were finalized. Investigations resulted in two arrests, three criminal informations, three plea agreements, and two

sentencings in the United States. In Afghanistan, one subject was arrested, three Afghans were barred from having military installation access, and two government contractors were terminated. SIGAR initiated 26 new investigations and closed 46, bringing the total number of ongoing investigations to 318. In addition, SIGAR's suspension and debarment program referred 16 individuals and 39 companies for suspension or debarment based on evidence developed as part of investigations conducted by SIGAR in Afghanistan and the United States.

Investigations highlights include:

- \$2 million from civil settlements
- A U.S. contractor pled guilty to fraud
- A former U.S. Army sergeant sentenced for fuel theft and kickback scheme
- \$14,500 in illicit proceeds seized
- Two convictions for money laundering
- A U.S. Army sergeant sentenced for fuel theft
- Employees terminated at the U.S. Embassy Kabul
- The arrest of an Afghan contractor
- The completion of the National Police Training Center

* Per statute, SIGAR may also report on products and events occurring after June 30, 2014, up to the publication date.

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“I’m not confident that if we were to leave at the end of 2014, that those forces would be sustainable. There are some significant capability gaps that have to be addressed in order for the Afghans to be able to do things that we have heretofore been doing for them.”

—*General Joseph F. Dunford*

1 SUSTAINABILITY OF RECONSTRUCTION GAINS



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Chairs at a school built, but never occupied, in Nangahar Province, were stripped for firewood. (U.S. Air Force photo)

CAN AFGHANISTAN SUSTAIN ITS RECONSTRUCTION GAINS?

Beyond the immediate challenge of insurgency and presidential transition, Afghanistan's next government faces another tough test: achieving self-sufficiency.

In its donor-assisted attempts to emerge from deep poverty and civil war, Afghanistan has become “almost unique” in its dependence on aid, according to the World Bank.¹ The United States and other international donors fund more than 60% of the Afghan national budget, as well as countless reconstruction programs and projects that currently operate off-budget. With the withdrawal of U.S. and Coalition troops, the responsibility for those programs and projects is being turned over to the Afghan government. Although donors have pledged large-scale aid for years to come, their generosity may wane as their presence declines. Meanwhile, the drawdown of military and other foreign personnel has already cooled economic activity, slowing the growth of government revenues.

In such a setting, Afghanistan's Ministry of Finance says, “Achieving fiscal sustainability is the main goal of Afghan government.”² A May 2014 International Monetary Fund (IMF) report concurs: “Afghanistan needs to move toward fiscal sustainability to reduce its dependence on donor support.”³

In 2013, the Afghan government's domestic revenue was only about \$2 billion, while its overall budget expenditures were \$5.4 billion. Donor grants made up the difference, funding 63% of the budget. Afghanistan's current budget, approved in January 2014, is about \$7.6 billion, with donor grants expected to fund about \$4.8 billion, or still more than 60% of the total.⁴ Figure 1.1 on the following page shows the increasing importance of donor assistance in covering Afghanistan's national-budget commitments.

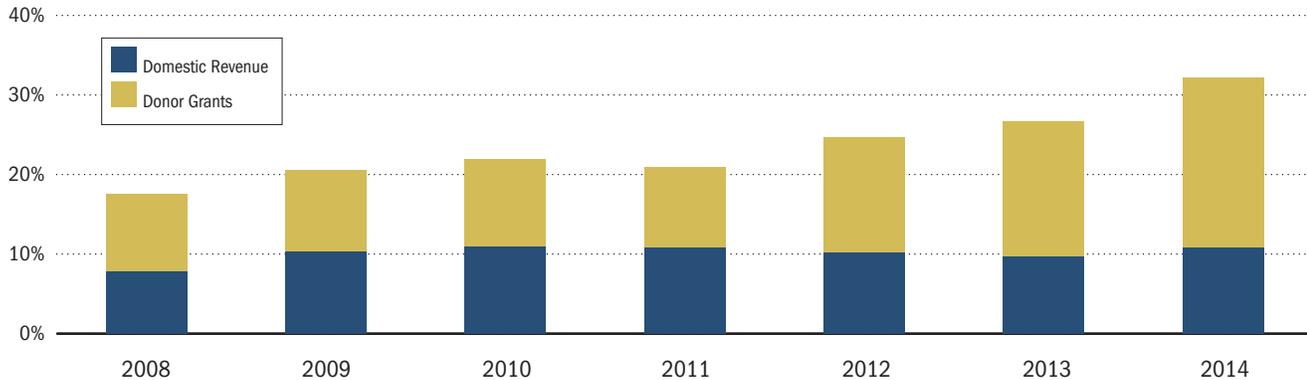
At the 2011 Bonn Conference, the international community declared that the transition to Afghan-led security in 2014 would be followed by a “Decade of Transformation” in which Afghanistan would “consolidate its sovereignty by strengthening a fully functioning, sustainable state in the service of its people.”⁵ However, the World Bank projects a large “financing gap” equivalent to 20% of Afghan gross domestic product (GDP) to persist

On- and Off-Budget Funds

U.S. FY 2014 appropriations for Afghan reconstruction are \$7.5 billion—by coincidence, almost the same as Afghanistan's current national budget of \$7.6 billion. But most of that U.S. aid, as well as most of other international donors' assistance, goes through programs and funds that are not part of the Afghan budget. See this report's funding review starting on page 73 for more information.

FIGURE 1.1

Domestic Revenue and Donor Grants in Afghan Budgets As percentage of Afghan GDP



Notes: Chart does not include donor grants that are executed off-budget, unmanaged by the Afghan government. "GDP" = gross domestic product.

Source: Asian Development Bank, "Asian Development Outlook 2014," April 2014, p. 156.

into 2025—a gap of nearly double the Afghan government’s projected domestic-revenue share of GDP.⁶

SECURITY COSTS ARE UNSUSTAINABLE WITHOUT LONG-TERM FOREIGN AID

The United States Congress has appropriated more than \$104 billion for the reconstruction of Afghanistan; other donors from around the world have contributed billions more. SIGAR calculates that by the end of 2014, the United States will have committed more funds to reconstruct Afghanistan, in inflation-adjusted terms, than it spent on 16 European countries after World War II under the Marshall Plan, see highlight, page 5.

The bulk of the U.S. aid effort—nearly \$62 billion of the \$104 billion appropriated since FY 2002—has gone to create and support the Afghan National Security Forces (ANSF).

The ANSF’s current authorized size is 352,000. To lessen the cost of sustaining it, the North Atlantic Treaty Organization (NATO) plans to reduce the force to 228,500 by 2017, if security conditions permit. The estimated cost of sustaining this smaller force is \$4.1 billion annually. NATO expects that the Afghan government would pay at least \$500 million annually beginning in 2015.

However, according to the latest Department of Defense (DOD)-commissioned independent assessment by the Center for Naval Analyses (CNA), “in the likely 2015–2018 security environment, the ANSF will require a total security force of about 373,400 personnel.”⁷ CNA cautions that “a



A 2013 SIGAR audit found that DOD was planning to purchase \$771.8 million of aircraft, like these Mi-17 helicopters, that the Afghans cannot operate and maintain. See Audit Report 13-13. (SIGAR photo by Jerome Goehring)

Afghan Reconstruction Funding Exceeds Real Cost Of Marshall Plan

Adjusted for inflation, U.S. appropriations for the reconstruction of Afghanistan exceed the funds committed to the Marshall Plan, the U.S. aid program that delivered billions of dollars between 1948 and 1952 to help 16 European countries recover in the aftermath of World War II.

Named for its author, Secretary of State and former Army general George C. Marshall, the plan has been called “one of the most successful long-term projects in American foreign policy.”¹⁰ A Congressional Research Service report says the Marshall Plan delivered about \$13.3 billion to its aid recipients before disbursements ended in June 1952.¹¹ The United Kingdom was the lead recipient, with \$3.2 billion.

Those nominal-dollar amounts are dwarfed by the \$104 billion Congress appropriated for Afghanistan reconstruction between fiscal years (FY) 2002 and 2014—until adjustment is made for the effects of inflation since 1948.¹² Comparison requires the adjustment: a dollar in 1950, for example, had roughly the purchasing power of 10 dollars in 2014.

Applying the year-end GDP Price Deflator from the U.S. Commerce Department’s Bureau of Economic Analysis to the streams of funding of both the Marshall Plan and Afghan reconstruction yields this result: “real” or inflation-adjusted Afghan-reconstruction appropriations amount to more than \$109 billion, versus an adjusted total of \$103.4 billion for the Marshall Plan.¹³ SIGAR’s calculations also indicate that the real value of Marshall Plan aid to the United Kingdom—about \$24.7 billion in today’s dollars—is less than a quarter of the funds appropriated through FY 2014 for Afghanistan reconstruction.

One critical difference should be noted: unlike Afghan-reconstruction funding, the Marshall Plan was not concerned with building and sustaining host-country armies and national police. But comparing the real purchasing-power funding of the two assistance programs does illustrate the scale of the U.S. aid effort in Afghanistan.



force of lesser size than 373,000 would, in our assessment, increase the risk of instability of Afghanistan and make success less likely for the U.S. policy goal.”⁸ The CNA estimates that a 373,000-strong ANSF would cost roughly \$5–6 billion per year to sustain.⁹

At that level, even if the Afghan government dedicated all of its domestic revenue toward sustaining the Afghan army and police, it still could only pay for about a third of the associated costs. All other costs—those required to pay civil servants and to operate and maintain roads, schools, hospitals, and other non-military infrastructure and programs—would have to be funded by international donors or abandoned, an unwise decision even if it were possible.

SUSTAINABILITY THREATENS DEVELOPMENT

It is questionable whether the Afghan government can sustain many non-security reconstruction programs in such sectors as health, education, and economic development. Built into many projects are requirements for parts and fuel that the Afghans cannot afford and technical skills that Afghan ministries cannot supply. Because of this, U.S.-built schools and health facilities often cannot be staffed or supplied. Moreover, some facilities have fallen into disrepair; others are unsafe, incomplete, or unsuited for their intended purposes.

SIGAR has confirmed that DOD, the United States Agency for International Development (USAID), the State Department, and other



The ANA may not be able to sustain the Mobile Strike Force Vehicles given to them. See Audit Report 14-85-AR. (SIGAR photo by Zach Rosenfeld)

U.S. agencies have not always consulted with Afghan agencies when planning programs or projects or given due regard to their financial and operational capacity for sustainment. The work of SIGAR and other oversight agencies as described in the “SIGAR Oversight” and “Other Agency Oversight” sections of this and previous SIGAR quarterly reports provide numerous examples.

The question of how to sustain the nonsecurity reconstruction programs deserves discussion because Afghanistan’s heavy reliance on donor assistance carries great risks for the country. The World Bank warns, “Any reduction in donor grants from planned levels would result in a loss of progress in poverty reduction, job creation, and service delivery.”¹⁴ Progress in those and other areas of Afghan life, however, are linchpins of the counter-insurgency strategy aimed at ultimately reducing Afghanistan’s need for a large security force.

DONOR SUPPORT MAY WEAKEN

At the height of the reconstruction effort in 2010–2011, the World Bank estimated total civilian and security aid were about as large as Afghanistan’s GDP, providing benefits but also side effects like “corruption, fragmented and parallel delivery systems, poor aid effectiveness, and weakened governance.”¹⁵

Aid has since fallen, but international donors who supplied more than 60% of the country’s national budget in 2013 still covered a “financing gap” equivalent to 7.7% of the country’s GDP.¹⁶ Much of the reconstruction effort, however, is “off-budget,” representing donor-funded programs and projects that the Afghan government does not control or fund.

As donors honor commitments to place more Afghan aid on-budget or simply transfer projects to Afghan control, the pressure on the budget will increase. The IMF and the World Bank “conservatively” estimate that Afghan maintenance of such donor-supplied capital stock—roads, buildings, utility infrastructure, equipment, and such—will cost 15% of Afghanistan’s GDP.¹⁷ Supporting such costs on the Afghan budget without donor support would require more than doubling the government’s revenue share of GDP, a major challenge.

The Afghan government has estimated its annual development-aid need at \$3.9 billion a year between 2013 and 2020.¹⁸ At various international conferences, the United States and other donors have pledged continuing aid through the “Decade of Transformation” ending in 2025, at which time Afghanistan is expected to achieve financial self-sufficiency. Afghanistan in turn has promised to achieve agreed-upon benchmarks under the Tokyo Mutual Accountability Framework (TMAF) as a condition for further donor assistance.



Sustaining non-security projects, like this DOD-funded road, could cost as much as 15% of Afghanistan’s GDP. See Special Project 14-72-SP. (ISAF photo)

RECONSTRUCTION SUSTAINABILITY

The TMAF benchmarks, however, are not carved in stone. USAID informed SIGAR this quarter that updating Afghan progress toward the “hard deliverables” required under the TMAF stopped in January 2014. The United States and international partners are developing a new set of targets for the future implementation of TMAF that will be discussed with the new post-election government. According to USAID, the process of finalizing these new targets will likely continue through the international conference on Afghanistan tentatively planned for November in London and into early 2015.¹⁹

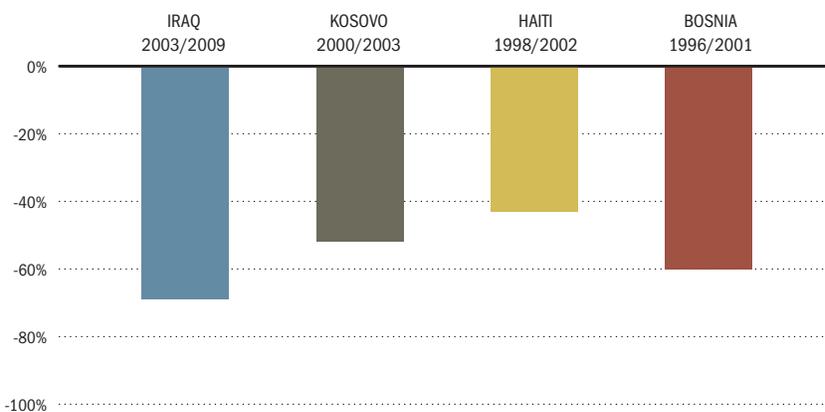
Even if Afghanistan satisfies current or future aid-qualifying benchmarks, international commitments are not necessarily guaranteed. A joint presentation by the World Bank and the Afghan Ministry of Finance notes, “Experience suggests that withdrawals of international troops reduce civilian aid, with implications for economic growth, fiscal sustainability, and service delivery.”²⁰ The Kabul-based Afghanistan Research and Evaluation Unit predicts a further reduction of aid after Western forces withdraw—with side effects including “capital flight, heightened risks for investments, and the collapse of drivers of economic growth such as reconstruction, logistics, and transportation.”²¹

Drawing on history, Dr. Anthony Cordesman of the Center for Strategic and International Studies has published a sobering set of slides, summarized in Figure 1.2, showing declines in development assistance that followed foreign-troop reductions in Iraq (minus 69%), Kosovo (minus 52%), Haiti (minus 43%), and Bosnia (minus 60%).²²

FIGURE 1.2

International Aid Reductions After Troop Reductions

Compared to year preceding reductions



Source: Anthony Cordesman, Center for International and Strategic Studies, “The Post-Election Challenges to Afghan Transition: 2014–2015,” slide deck, 5/18/2014, slide 6.

Declarations of intent notwithstanding, decisions and disbursements of aid are sensitive to changes in political and geopolitical circumstances. Aid pledges are no more carved in stone than are aid-qualifying benchmarks. As troop withdrawals accelerate, public opinion in donor countries could push lawmakers to consider aid cutbacks. Surveys in the United States,²³ the United Kingdom,²⁴ and Germany²⁵ have found widespread disaffection with the Afghanistan mission and with overseas involvements in general. In any case, “Only a few donors are able to forecast aid flows up to 2017 and beyond,” says a 2013 Afghan Ministry of Finance report. “Others are constrained by their annual budgeting processes and are not able to provide a clear indication of future allocations of their aid.”²⁶

Given the probabilities that Afghanistan will fail to meet some of its Tokyo-conference aid-qualifying benchmarks or that some large donors will revise their plans, or both, the question is whether Afghanistan can do more to meet its own revenue requirements.

WHY IS AFGHANISTAN'S DOMESTIC-REVENUE COLLECTION SO LOW?

The IMF recently noted that “Afghanistan has one of the lowest domestic revenue collections in the world, with an average of about 9 percent of GDP in 2006–13 compared to about 21 percent in low-income countries.” The reasons, the IMF said, include “a very low starting point, low compliance, opposition to new taxes, and a limited set of taxes.”²⁷

Afghanistan’s low level of fiscal effort is a problem. Developing countries in Asia averaged a 17.8% government-revenue-to-GDP ratio in recent years, according to the Asian Development Bank—almost twice the fiscal effort of Afghanistan.²⁸ The London School of Economics economist Ehtisham Ahmad presented a paper to a “Group of 24” developing countries this year arguing that countries collecting less than 10% of GDP “will likely have inadequate resources for the minimum public investment for infrastructure or its components, including education and R&D, as well as operations and maintenance.”²⁹

Afghanistan is of course operating from a low starting point as one of the poorest countries in the world. But fiscal effort is a matter of ratios, not absolutes. As of 2012, the CIA estimated that Afghanistan had the 207th-lowest ratio of taxes and other revenues to GDP. The 2013 world average was 30.3%; the U.S. federal tax/GDP ratio, counting Social Security and similar taxes, was 22%.³⁰

Taxation is clearly a challenge in a country like Afghanistan, with no tradition of strong central government, a mostly rural workforce, a large informal economy, and ministries with limited capacity. Still, the small share of GDP claimed for Afghan domestic revenues may raise questions whether the country’s fiscal effort is sufficiently robust, and how badly tax



A 2014 SIGAR audit found many challenges that will limit customs revenue from border crossings, such as the one seen here, as a sustainable source of income for Afghanistan. See Audit Report 14-47-AR. (SIGAR photo by Martin Wilson)

RECONSTRUCTION SUSTAINABILITY



The Gardez hospital, shown here under construction, has annual operations and maintenance costs that are too high to be sustained by the Afghan government. See Inspection Report 14-6-IP and Audit Report 13-9. (SIGAR photo by Lise Pederson)

evasion, smuggling, corruption, fraud, and other “leakages,” as the IMF puts it, are cutting into the intended yield from current tax laws.

As DOD has reported to Congress, “Corruption, ineffective program monitoring, budget shortfalls at all levels, inability to generate revenue, and limited public financial management capacity continue to plague the [Afghan] national government.”³¹ To its credit, the Afghan Ministry of Finance website recognizes that problems exist: “Skill levels are low. Systemic corruption of tax officials is a serious threat to future tax collection. . . . Methods, systems, and work practices to administer taxes are inefficient and do not reflect modern tax administration practices. . . . Compliance with the tax laws is low.”³²

Afghanistan’s economic and institutional weaknesses also present a problem for the medium and long term. They undermine the government’s prospects of achieving its TMAF goals of increasing domestic revenue generation to 15% of GDP by 2016 and 19% by 2025. “The current decline in revenue,” says the World Bank, “therefore poses not only risks to long-term fiscal sustainability but also to the achievement of TMAF targets.”³³ Failure to achieve TMAF goals could in turn reinforce any donor inclinations to cut aid, further deepening the fiscal-sustainability problem.

WHAT IS TO BE DONE?

If Afghanistan can no longer rely on economic stimulus from the presence of Coalition personnel and cannot assume that donor assistance will be adequate to fund its own needs and take on the large accumulation of off-budget projects, what can it do? The IMF's Mission Chief for Afghanistan explained in May 2014 that the government's strategy for increasing revenues has four main pillars:³⁴

- improved tax compliance
- implementing a value-added tax (VAT)
- developing the Afghan mining sector
- imposing new taxes in addition to a VAT

Improving tax compliance is a worthy objective, but such efforts will take time and, given that current Afghan tax laws bring in less than 10% of GDP, might only marginally augment inflows to the Ministry of Finance.

Afghans pin great hopes on mining for revenue generation, partly because there are few good alternatives. As the World Bank observes of Afghanistan, "Education levels are too low and the manufacturing sector too underdeveloped (in size and capacity) to expect leapfrogging the classic pattern of structural transformation in which a natural resource-based economy is transformed into a diversified and productive economy dominated by manufacturing and services."³⁵

Enacting a new mining law is a key TMAF benchmark that can affect future levels of international aid to Afghanistan. The Afghan parliament has recently passed a new mining act, but it has not been signed into law. As currently written, however, details of the law might still deter investment and fail to meet World Trade Organization (WTO) standards—another potential problem, as accession to the WTO is also a TMAF benchmark for Afghanistan.³⁶

Even if a new law were in place, the mining sector appears unlikely to generate substantial revenues for years to come. The World Bank projects government revenues from mining "could reach 2–4% of GDP in the early 2020s."³⁷ If that projection materialized, however, it would still not close Afghanistan's on-budget fiscal gap, current or projected.

Other export possibilities are less promising. Afghanistan's 2012–2013 exports of \$414.5 million are nearly 24% below the 2008–2009 peak of \$545 million, so revenue potential may be modest. Principal exports are carpets and rugs, dried fruits, and medicinal plants.³⁸ The CIA adds to that list opium and gems.³⁹ But opiates are not part of the licit economy, and gems are easy to smuggle, so their contributions to government revenue are limited.

The item on the IMF sustainability-enhancing list with the best near-term prospects for generating government revenue is the value-added tax, or VAT.

WHAT WOULD A VAT DO?

The VAT, a common form of taxation outside the United States, operates much like a sales tax, falling on the purchaser of the taxed good or service. It differs from a sales tax in that it is levied at each stage of production.

For example, as shown in Figure 1.3, a lumber company charges VAT on its sales to the furniture maker, who charges VAT on its sales to the furniture store, who, in turn charges VAT on its sales to the final consumer. Each seller in the process remits its VAT receipt—minus the VAT it paid on its own purchases—to the government. In this way, the government taxes only the economic “value added” at each step of the commercial process.⁴⁰

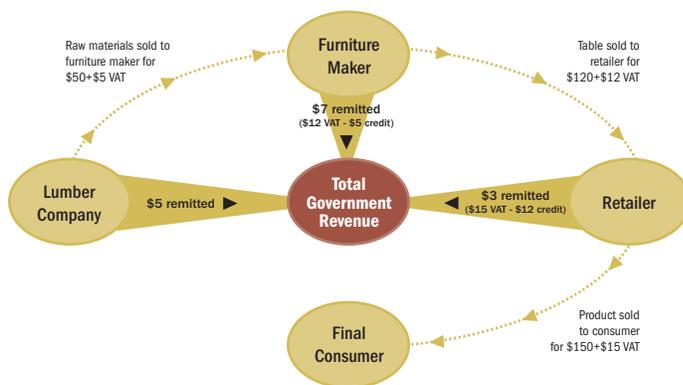
The sequence of taxable transactions gives the VAT an advantage—at least from the government’s view—over a traditional sales tax: It creates a transaction record at every step, making it harder for people to evade taxes.

Establishing a VAT in Afghanistan would be important not only as a major change in tax policy, but also as a potential generator of large sums of revenue: VAT proceeds supply nearly a third of government revenue for member states of the European Union, and are the EU’s largest single revenue source.⁴¹

The Afghan parliament agreed with the IMF, which maintains an Extended Credit Facility for Afghanistan, to introduce VAT legislation in 2014.⁴² Both houses of the Afghan parliament passed VAT bills this spring, but at last report a combined bill awaits a joint commission session to reconcile differences.⁴³ The IMF reports that the bill faces opposition, the timing of ultimate passage is uncertain, and implementation could take a year after passage.⁴⁴

FIGURE 1.3

How a Value-Added Tax Works



Note: Assume 10% VAT for purposes of illustration.

Source: GAO Testimony GAO-11-867T, *Value-Added Taxes: Potential Lessons for the United States from Other Countries' Experiences*, 7/26/2011, p. 3.

If Afghanistan does succeed in establishing a VAT, however, a variety of pitfalls could result in a lower contribution to Kabul's revenues than might be projected.

COULD A VAT BOLSTER AFGHAN FISCAL SUSTAINABILITY?

The Afghan Ministry of Finance appears to have high expectations for a VAT. Its recent first-quarter report gave the results of computer modeling of a VAT tax: "increase in total revenue collection by 23% and increase in gross domestic product by 1.3% due to nominal increase in overall price level."⁴⁵

That would indeed be a significant boost to Kabul's revenues, though not nearly enough, even combined with hoped-for mining revenues, to fill the fiscal gap in its current budget. Other countries' experience with a VAT, however, reveal several reasons why actual proceeds may fall short of the government's hopes and computer-model projections.

The European Commission notes member states collect VAT revenues "far below the level that could be collected theoretically" because of widespread exemptions, targeted reduced rates, and "a high gap in tax collection" (i.e. fraud and evasion).⁴⁶ Afghan policy makers could, of course, choose not to weaken and complicate the VAT by giving exemptions, but that choice could trigger struggles with aggrieved constituencies, including vested interests.

Compliance can be a challenge. In the United States, the Government Accountability Office (GAO) has told Congress that VAT problems can include phony businesses that collect VAT and then disappear, firms that fail before remitting VAT, merchants who charge VAT-free cash prices and underreport sales, people who create bogus VAT receipts to get refunds, and sellers who misreport classifications to pay a lower VAT rate.⁴⁷

European Union members with long experience in VAT administration still have trouble collecting it.⁴⁸ They are not alone. Developing countries like India, Bangladesh, Uzbekistan, and Nepal who use the VAT face even greater challenges. Bangladesh has struggled to tax the large informal sector of its economy.⁴⁹ Pakistan has problems with excessive exemptions and refund requests supported by fake invoices.⁵⁰ Afghanistan, where electricity, computers, and literacy are in even shorter supply, would find it even more difficult to enforce compliance.

The UK's Department for International Development (DFID) has been helping Afghanistan prepare for the VAT as part of a nearly \$20 million Tax Administration Project. In its latest annual review of the project, DFID says "VAT will provide a welcome new revenue stream but may also introduce new fraud risks," and predicts "a number of very significant challenges in terms of operation, compliance and communications" as Afghanistan implements a VAT.⁵¹

WHAT, THEN, IS THE OUTLOOK?

Afghanistan's fiscal sustainability will be affected by variables including its economic growth, legal and regulatory framework, duration and impact of the insurgency, aid decisions by foreign donors, ministerial capacity, progress against the illicit economy, and citizens' compliance with tax laws.

However the variables play out, the consensus view is captured in DFID's crisp conclusion that "Afghanistan is many years away from achieving fiscal sustainability"⁵² and the IMF's opinion that fiscal sustainability "calls for further reforms and may take more than a decade."⁵³

Unfortunately, time and donor benchmarks are pressing on Afghanistan. "By 2021," DOD reports, "domestic revenues are expected to cover only 35 percent of projected expenditures. Revenue shortfalls will force Afghanistan to make difficult choices between the public services it provides, balancing costs for security, health and education services, infrastructure projects, and maintenance."⁵⁴ Extreme cuts or poorly balanced trade-offs could have unsavory consequences for economic growth, government legitimacy, and for the counterinsurgency effort.

Considering Afghanistan's current economic and political strains, financing challenges, and uncertainties as to the scope and duration of future donor assistance, American lawmakers and policy makers might wish to consider taking appropriate measures to ensure that stakeholder entities like State, DOD, and USAID:

- engage closely with other donors to stress the importance of coordinated effort and avoidance of large or abrupt changes in aid flows
- maximize support to the Afghan government in efforts to suppress money laundering, corruption, diversion of customs revenues, and other "leakages"
- intensify advisory services to promote Afghan economic development to take up the fiscal slack created by the reduced international presence
- encourage Afghanistan to take steps to improve its poorly rated business climate⁵⁵
- offer Afghan ministries technical advice on scenario modeling, program-prioritization, and triage techniques to help them make informed and systematic decisions on cutbacks in case domestic revenues and donor grants fall chronically short of covering planned outlays

None of these measures requires large new appropriations by Congress. But they could pay substantial dividends if they help the incoming Afghan government raise revenues by expanding its tax base with measures to stimulate higher personal incomes and business earnings. Increasing the flow of sustainable domestic funding for Afghan infrastructure investments and public services—and developing a sound decision-making capacity to weather aid cutbacks—would be important contributions to protecting the gains of the long reconstruction effort.



President Karzai and Afghan lawmakers have struggled to meet donors' assistance benchmarks while seeking to boost domestic revenues. (Radio Free Europe/Radio Liberty photo)

“Despite the drawdown of U.S. and Coalition forces [from Afghanistan], our mission there is far from over. With almost \$18 billion appropriated but not yet spent in the pipeline, and probably another \$6 to \$10 billion promised annually for years to come, Afghanistan reconstruction should still be relevant to every U.S. taxpayer and policy maker.”

—*Special Inspector General John F. Sopko*